89-1616

Case No.
IN THE SUPREME COURT OF THE UNITED STATES
OCTOBER TERM 1990

AMERICAN TECHNOLOGY RESOURCES,
JAMES A. PITTS, ALBERT S. PITTS
and THOMAS M. PITTS,

Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI FROM JUDGMENT OF THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT UPHOLDING THE IMPOSITION OF THE PENALTY PURSUANT TO 26 U.S.C. SECTION 6700

BRIEF FOR PETITIONERS

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QUESTION PRESENTED FOR REVIEW

Whether the Circuit Court erred in its conclusion that the District Court correctly upheld the imposition of the penalty pursuant to 26 U.S.C. Section 6700 for participating in the sale of an abusive tax shelter. The resolution of this question depends upon whether the value of the ATR distributorships was directly related to the availability of a tax deduction or credit set out in the ATR sales materials. This requires the Court to determine whether the tax deductions set forth in the sales materials increase as the value of the distributorships sold increase, or whether value is irrelevant to those tax deductions, being based upon the amount of debt incurred by the distributor, rather than being limited by the value of the distributorship.

LIST OF PARTIES

All of the parties are listed in the caption.

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REFERENCE TO OFFICIAL REPORTS

The District Court Opinion is reported at 709 F.Supp. 610 (E.D.Pa. 1989). The Circuit Court Opinion is reported at 893 F.2d 651 (3d Cir. 1990).

GROUNDS UPON WHICH JURISDICTION IS INVOKED

(1) The date upon which the Circuit Court Judgment was issued was January 17, 1990.

(2) The Petitioners' Petition for Rehearing was denied, and no order was sought respecting an extension of time to file a Petition for Certiorari.

(3) This Petition for a Writ of Certiorari is authorized under 28 U.S.C. Section 1254(1).

STATUTES AND REGULATIONS

26 U.S.C. Section 1012:

> The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.

26 U.S.C. Section 1253(a):

> (a) General rule.- A transfer of a franchise, trademark, or trade name shall not be treated as a sale or exchange of a capital asset if the transferror retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name.

26 U.S.C. Section 1253(d)(1):

> (d) Treatment of payments by transferree.-
>
> (1) Contingent payments.- Amounts paid or incurred during the taxable year on account of a transfer, sale, or other disposition of a franchise, trademark, or

trade name which are contingent on the productivity, use, or disposition of the franchise, trademark, or trade name transferred shall be allowed as a deduction under section 162(a) (relating to trade or business expenses).

26 U.S.C. Section 6700:

(a) Imposition of Penalty.- Any person who-

(1)(A) organizes (or assists in the organization of)-

(i) a partnership or other entity,

(ii) any investment plan or arrangement, or

(iii) any other plan or arrangement, or

(B) participates in the sale of any interest in an entity or plan or arrangement referred to in subparagraph (A), and

(2) makes or furnishes (in connection with such organization or sale)-

(A) [omitted because not involved in this case] or

(B) a gross valuation overstatement as to any material matter,

shall pay a penalty equal to the greater of $1,000 or 20 percent of the gross income derived or to be derived by such person from such activity.

(b) Rules relating to penalty for gross valuation overstatements.-

(1) Gross valuation overstatement defined.- For purposes of this section, the term "gross valuation overstatement" means any statement as to the value of

any property or services if-

(A) the value so stated exceeds 200 percent of the amount determined to be the correct valuation, and

(B) the value of such property or services is directly related to the amount of any deduction or credit allowable under chapter 1 to any participant.

(2) Authority to waive.- [omitted because petitioners do not seek review of the refusal to waive the penalty]

(c) Penalty in addition to other penalties.- The penalty imposed by this section shall be in addition to any other penalty provided by law.

26 U.S.C. Section 6703(c):

(c) Extension of period of collection where person pays 15 percent of penalty.-

(1) In general.- If, within 30 days after the day on which notice and demand of any penalty under section 6700, 6701, or 6702 is made against any person, such person pays an amount which is not less than 15 percent of the amount of such penalty and files a claim for refund of the amount so paid, no levy or proceeding in court for the collection of the remainder of such penalty shall be made, begun, or prosecuted until the final resolution of a proceeding begun as provided in paragraph (2).

(1) Person must bring suit in district court to determine his liability for penalty.- If, within 30 days after the day on which his claim for refund of any partial payment of any penalty under section 6700, 6701, or 6702 is denied (or, if earlier, within 30 days after the expiration of 6 months after the day on which he filed the claim for refund), the person fails to begin a proceeding in the

appropriate United States district court for the determination of his liability for such penalty, paragraph (1) shall cease to apply with respect to such penalty, effective on the day following the close of the applicable 30-day period referred to in this paragraph.

STATEMENT OF THE CASE

These four cases have been consolidated by each of the Courts below for purposes of filing Opinions in each. They are suits for refund of income taxes assessed against Petitioners American Technology Resources (hereinafter "ATR"), James A. Pitts, Albert S. Pitts and Thomas M. Pitts, pursuant to the provisions of 26 U.S.C. Section 6700. As set forth in the statute, these income taxes are actually a penalty for selling a plan in which income tax benefits are promised, but are actually not available, for certain reasons. By agreement of the parties, contained in the Pre-Trial Order, this case is limited to consideration of whether the sales materials contained a gross valuation overstatement which is directly related to the availability of a tax deduction or credit set forth in those materials. Fifteen (15%) percent of the assessed penalty was paid pursuant to 26 U.S.C. Section 6703(c), entitling Petitioners to file this action.

ATR is a corporation doing business in Media, Pennsylvania. ATR is engaged in the business of selling interactive videodisc systems and courseware. Petitioner Albert S. Pitts (hereinafter "Mr. Pitts") became aware of ATR in 1982. ATR had entered into an agreement with United States Motion Picture Institute (hereinafter "USMPI"), a non-profit corporation not a party to the instant litigation, to sell territorial distributorships for the sale of ATR's products. Each distributorship entitled the distributor to the exclusive right to sell ATR product within its territory for a term of forty-three (43) years. In exchange for this distributorship, the distributor agreed to pay an amount, call the "Contingent Principal Sum," due to USMPI in twenty-three (23) install-

ments. This sum was computed on a formula dependent upon the population of the territory. By doing business in years one, two and three, the distributor would incur liability for twenty (20%) percent of the Contingent Principal Sum. This sum is due twenty years after it was incurred. No further liability would be incurred until year eleven, and for each of the next twenty years in which the distributor did business, payments are paid on obligation from sales made in the territory, two (2%) percent of the Contingent Principal Sum is incurred. These debts are due in twenty years.

Each distributor received an information package prior to signing the distributorship agreement. This information advised the distributor that he could deduct the amount of Contingent Principal Sum which was incurred in the year in which it was incurred, so long as he agreed to be personally liable for the debt. He was also told that he should elect the accrual method of accounting in order to obtain these income tax deductions.

While each distributor who follows the instructions in the sales materials is personally liable for the full amount of incurred debt, a portion of his yearly profits is withheld to reduce the Contingent Principal Sum. However, as the full amount of profits are taxable as income, he is taxed currently on an amount greater than he receives. Any amount not paid for in this fashion twenty years from the date the debt was incurred must be paid by the distributor out of his pocket, because of the election, essential to the availability of the deduction in issue, to be personally liable for the debt.

Through 1987, the distributors had collectively incurred debt in the approximate amount of $12,000,000. In 1984, the distributors collectively received cash distributions of $12,081, and their Contingent Principal Sums were reduced by $4,066. In 1985, the distributors collectively received $24,448, and their Contingent Principal Sums were reduced by $29,744. In 1986, the distributors collectively received $23,753, and their Contingent Principal Sums were reduced by $59,113. Payments have continued in subsequent years.

Although Mr. Pitts began his activities as a salesman of ATR distributorships, he became President of ATR, and he

and his sons, Petitioners James and Thomas Pitts, became owners of 77.5% of ATR's stock. All of them became involved in selling distributorships, and now make their living selling ATR products.

BASIS OF FEDERAL JURISDICTION

Jurisdiction over these suits for refund of income taxes assessed and paid, to the extent of fifteen (15%) percent, as permitted pursuant to 26 U.S.C. Section 6703(c), was granted to the United States District Court pursuant to the provisions of 28 U.S.C. Sections 1340 and 1346(a)(1).

STATEMENT OF APPELLATE JURISDICTION

Jurisdiction over this appeal from the final judgments rendered by the United States District Court for the Eastern District of Pennsylvania was granted to the United States Circuit Court of Appeals by the provisions of 28 U.S.C. Section 1291. Appeal to the United States Court of Appeals for the Third Circuit was proper pursuant to the provisions of 28 U.S.C. Section 1294.

ARGUMENT

Review of this case is requested for two reasons. First, there are approximately thirty cases before either the Internal Revenue Service or the United States Tax Court concerning this transaction, and the resolution of this matter will impact directly upon those cases. The parties to these cases live in several different states, and would involve several different Courts of Appeal, which could easily result in a conflict. Review is needed now, however, because should such a conflict result, and be resolved favorably to the other taxpayers, these taxpayers will be left with an unfavorable result, as this case was tried first. Trial of some of the other

cases commenced in the United States Tax Court on March 19, 1990. Judge Steven Swift recognized that the value and cost (tax basis) are separate and distinct concepts. See appendix pages **XXX**

However, more importantly, review is sought because the Third Circuit Court of Appeals has sanctioned a departure from the usual course of judicial proceedings which took place in the District Court for the Eastern District of Pennsylvania. In most judicial proceedings, the law is carefully considered and applied to the facts at issue in the case. In this proceeding this has not been done. A penalty for the participation in the sale of an abusive tax shelter has been imposed without even considering whether or not the property sold was a tax shelter, which requires a conclusion as to whether the investors are entitled to claim the deductions described in the offering materials.

Pursuant to 26 U.S.C. Section 6700, the District Court considered the value of the property being sold, territorial distributorships, and concluded that the true value exceeded the value stated in the sales material by 200%. It then held that since the sales price and the total tax deductions which would be claimed were the same, the value of the overvalued property was directly related to the availability of a tax deduction or credit. This allowed the Court to impose the penalty. However, the Court failed to include any tax analysis in its Opinion, which led to its incorrect conclusion that the value was directly related to the availability of a deduction or credit. Instead it merely assumed the existence of a cause and effect relationship between the two.

The Third Circuit glossed over this point. It correctly states that the statute refers to whether the deduction is directly related to the <u>amount</u> of the deduction or credit. However, it simply assumes this is true, stating that the amount incurred is the amount deductible, and that this amount is a set percentage of the Contingent Principal Sum, which is the same as the value placed on the distributorship by Appellants. However, simply stating that the value placed on the distributorship is the same as the deduction is a far cry from establishing a cause and effect relation between the two. Had

it carefully analyzed the tax consequences of the distributorship program, it would have concluded that a change in the "true" value has no effect on the amount of tax deductions available. If this is so, then the penalty does not apply, since the value is not directly related to the availability of a deduction or credit.

The importance of establishing a cause and effect relationship can be more easily understood by concentrating on the definitionof the term "gross valuation overstatement," which requires that "[T]he value of such property... is directly related to the amount of any deduction or credit allowable under chapter 1 to any participant." 26 U.S.C. Section 6700(b)(1)(B). This is an important limitation set out by the statute on the scope of the inquiry. This limitation is that the issue in the case is <u>not</u> whether the participants would be entitled to the deductions or credits claimed; rather it is whether the materials contain a gross valuation overstatment <u>directly related</u> to such a deduction or credit. The distributors were told they were entitled to a deduction, pursuant to 26 U.S.C. Section 1253(d)(1), based upon the following language contained in that Section:

> Amounts paid <u>or</u> <u>incurred</u> during the taxable year on account of a transfer... of a franchise... which are contingent on the productivity, use or disposition of the franchise... shall be allowed as a deduction under section 162(a)..."

(Emphasis added). Therefore, the deduction arises by reason of incurring an obligation to pay, and the deduction is in the amount which the distributor agrees to pay. Nowhere does the "true" value of the territorial distributorship enter into this equation.

This Code section and its interplay with the value of the franchise purchases is best explained by a simple example. If a distributor pays one million dollars in cash for a territorial distributorship worth only one hundred thousand dollars, there would be no dispute the he is entitled to a deduction in the full amount of cash paid, as he has clearly "paid or incurred" that amount by paying it. There is no economic

incentive to overpay in order to obtain a tax deduction, since the tax rates are always less than 100%. Similarly, if he pays for the distributorship by means of a short-term, recourse debt, due, for example, in thirty days, he is still clearly entitled to a deduction in the amount of one million dollars, for he has clearly incurred the debt by becoming legally bound to pay it. Again, there is no economic incentive to pay a dollar in order to obtain a tax deduction worth less than a dollar. Similarly, in an ordinary real estate transaction, financing with principal due thirty or more years in the future is not unusual, and is routinely accepted by appellee. It is only with respect to the specifics of this transaction that appellee contends that the debt is not an amount incurred within the meaning of 26 U.S.C. Section 1253(d)(1).

The deduction in issue is sought pursuant to the provisions of 26 U.S.C. Section 1253(d)(1), as an amount paid or incurred for the use of a franchise. The amount incurred is simply the amount agreed to be paid. The debt for which the distributor became personally liable is that amount. Whether or not the value of the underlying property is equal to the debt is irrelevant, because the agreed amount of debt must still be paid, regardless of true value, once the distributor signs the contract. It is axiomatic that a Court will not review the sufficiency of consideration, so it is clear that had the distributor sought to defend a suit to collect on the contract on the ground that the value of the underlying property is far less than what he agreed to pay (absent actionable fraud) he would lose a Motion for Judgment on the Pleadings.

The only difference is one of timing, as the principal balance of the notes theoretically may not be paid for twenty years, presumably with "cheaper" dollars due to the time value of money. However, the Internal Revenue Code does not account for the time value of money. Follander v. Commissioner, 89 T.C. 943 (1987). Depreciation deductions in excess of cash paid initially to the extent of recourse debt are available every day, for example, to an investor in real estate. Appellee does not seek to bar deductions in those circumstances, as it is well aware that such deductions are proper under the law.

The type of case to which the penalty in issue should be applied can be seen in United States v. Turner, 601 F.Supp.

757 (E.D. Wis. 1985), aff'd by order sub. nom. United States v. Smith, 787 F.2d 595 (7th Cir. 1986). In that case the selling price of a unit of property was $80,000, and because that was more than 200% of the value as actually determined, the penalty was applied. Again, there was no detailed analysis of the tax consequences. By performing one it can be shown why the penalty was correctly applied in that case, and why it cannot apply to this one.

In Turner, the "deduction or credit" in issue was the investment tax credit. Pursuant to 26 U.S.C. Section 46(a), the amount of the credit equals a specified percentage of the "qualified investment." The qualified investment is defined in 26 U.S.C. Section 46(c) as a percentage of the basis of property described in 26 U.S.C. Sections 38 and 48(b). Basis, in turn, is defined, as a general rule, by 26 U.S.C. Section 1012, as the cost of the property. The definition of cost contained in that Section has nothing to do with value.

However, there is more involved in a complete analysis. The concept of basis has a limit, namely that "basis" is limited to fair market value. Majestic Securities Corp. v. Commissioner, 120 F.2d 12 (8th Cir. 1941); Bizub v. Commissioner, T.C. Memo 1983-280 (1983). The latter case illustrates a situation in which the penalty in issue might apply; namely the use of non-recourse debt to finance a movie. Large depreciation deductions were claimed. The Court stated:

> However, where the purchase price and the principal amount of the nonrecourse note unreasonably exceeds the fair market value of the property securing the note, the face amount of the note will not be included in the depreciable basis of the property.

Bizub, at 46 TCM 207. According, the claimed depreciation deductions were denied for lack of depreciable basis. Similarly, in Turner, the claimed investment tax credits were denied because, although the Court does not specify, the basis for determining the amount of the credit can not exceed the fair market value of the property. This established a direct relation between the gross valuation overstatement and the credit claimed to be allowable, just as 26 U.S.C. Section 6700 requires.

The argument is that simple. The importance of this case lies not in resolving an existing conflict between the Circuits, but in setting a precedent, to require the Courts, and the Internal Revenue Service, in considering the complex penalties set forth in the Internal Revenue Code, to actually analyze the transaction. Integrity in tax administration is threatened where a penalty can be assessed for selling an abusive tax shelter, where there is no analysis which tells us whether the tax deductions sought are available. Appellants are not convinced that the tax deductions set forth in the matertials are not available, because no reasoning has been set forth, despite the careful technical analysis contained in their briefs. Yet, if this case is not reviewed, at least thirty distributors may be told that the Third Circuit has concluded that their tax deductions are denied, without specifically considering whether they are available. What has occurred is that the Internal Revenue Service has labeled this matter an abusive tax shelter and imposed penalties for it being an abusive tax shelter, without being required to explain, using logical analysis of the statutes involved, why this is an abusive tax shelter.

CONCLUSION

For the reasons set forth above, it is respectfully requested that this Honorable Court grant this Petition and issue a Writ of Certiorari to review the conclusion reached below.

Respectfully submitted,

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CERTIFICATE OF SERVICE

This is to certify that three copies of this document have been mailed, by United States Post Office, in a prepaid wrapper, addressed as follows:

Solicitor General
Department of Justice
Washington, D.C. 20530

Dated: Thursday April 12, 1990

EDWARD NEWMAN

ENTRY OF APPEARANCE

The undersigned, being admitted to practice before this Honorable Court, enters his appearance on behalf of the four Petitioners, American Technology Resources, James A. Pitts, Albert S. Pitts and Thomas M. Pitts.

EDWARD NEWMAN

I

AMERICAN TECHNOLOGY RESOURCES,
Albert S. Pitts, James A. Pitts and Thomas M. Pitts

v.

UNITED STATES of America,

Civ. A. No. 86-5769.

United States District Court,
E.D. Pennsylvania.

March 29, 1989.

Howard Philip Newman, Wyncote, Pa., for plaintiffs.
Noreene C. Stehlik, Office of Special Litigation, Tax Div., Dept. of Justice, Washington, D.C., for defendant.

MEMORANDUM OF DECISION
UNDER FED.R.CIV.P. 52(a)

LUDWIG, District Judge.

In 1986, the Internal Revenue Service assessed penalties against plaintiffs American Technology Resources, Albert S. Pitts, James A. Pitts, and Thomas M. Pitts for promoting abusive tax shelters as to tax years 1982 and 1983. 26 U.S.C. § 6700. Pursuant to 26 U.S.C. § 6703(c), plaintiffs, having paid 15 percent of the penalties, filed this action contesting their liability.[1] Jurisdiction exists under 28 U.S.C. §§ 1840 and 1846(a)(1).

I.

The following statement of facts is based on the parties' extensive pretrial stipulation.

Plaintiff American Technology Resources (ATR) is a Nev-

1. A refund of the penalty amounts paid is also sought. The penalties assessed were as follows: American Technology Resources—$194,425; Albert Pitts—$6,000; Thomas Pitts—$8,000; James Pitts—$4,000.

ada corporation, incorporated in 1982, with its principal place of business in Media, Pennsylvania. On June 1, 1983 its stock was issued to plaintiff Albert Pitts and Thomas Pitts. As of 1987 they owned 77.5 percent of the issued and outstanding shares. The other shareholders have not been active in the operation of the corporation.

Albert Pitts became president of ATR in 1983 succeeding Rolph Fuhrman.[2] United States Motion Picture Institute (USMPI) is a non-profit Nevada corporation, and since 1982 Rolph Fuhrman has been its president. ATR Financial, also a Nevada corporation incorporated in 1982, became wholly owned by ATR in 1983. In 1982, Fuhrman was its president. ATR Product Marketing is a sole proprietorship of Albert Pitts, formed by him in 1982.

ATR produces and sells an "ATR Video Image System," which includes high-technology video-image storage and retrieval products, services and equipment. On November 15, 1982 it entered into an agreement with USMPI permitting USMPI to sell ATR territorial distributorships. In 1982 and 1983, 34 such distributorships were sold pursuant to agreements signed by representatives of ATR and USMPI and by the distributor. Each agreement granted the distributor the exclusive right to market the ATR system—"product"—within a designated territory in New Jersey, eastern Pennsylvania, or Delaware for a term of 43 years. These distributorships were sold to 32 individuals and two limited partnerships, ATR Philadelphia and ATR Delaware. Each distributor also entered into a "Consulting Agreement" with ATR Product Marketing, under the terms of which ATR Product Marketing manages, administers, and supervises the sale, lease and licensing of the ATR product for the distributor.

In return for the right to market the ATR product, each individual distributor agreed to incur a liability called a "Contingent Principal Sum," due USMPI in 23 installments: An "Incurred Annual Contingent Amount" equal to 20 percent of "Contingent Principal Sum" payable in each of years one, two

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2. Although not a part of the pretrial stipulation, these facts are uncontested.

and three; no amount in years four through 10; and two percent of the "Contingent Principal Sum" for 20 years thereafter. The "Contingent Principal Sum" varied, depending on the population of the distributorship's territory.

Most of the distributors also paid to ATR Financial in each of the first three years a "Guaranteed Performance Deposit" equaling five percent of the "Contingent Principal Sum." These payments were not credited against the "Contingent Principal Sum." They were the only specific cash payments a distributor was required to make.

Each individual distributor received a promotional package before signing the distributorship agreement. According to the promotional material, a distributor could elect to be personally "at risk" for all or a part of the 20 percent "Incurred Annual Contingent Amounts" due in years one, two, and three. This personal obligation became due in 20 years as reduced by the distributor's allocation of profits from sales of ATR product. The promotional material also represented that a distributor could deduct on his federal income tax returns the amount of the "Incurred Annual Contingent Amount" for which he assumed personal liability. A distributor could thereby obtain a federal income tax deduction of up to four times the payment to ATR Financial.

Under the agreement between ATR and USMPI, USMPI was to retain 25 percent of the "Contingent Principal Sum" payments and was to lend the balance, of 75 percent, to ATR without interest for an indefinite term. In 1982 and 1983, USMPI did not receive any payment on account of a "Contingent Principal Sum." Effective March 1, 1984, ATR, USMPI, ATR Product Marketing, and most of the distributors entered into a "Profit-Sharing and Joint Management Agreement." Under this agreement, all net profits or losses from ATR product sales made within New Jersey, eastern Pennsylvania and Delaware were to be divided among the distributors in proportion to the distributors' payments.

The following elections of personal liability by distributors and financial activities on the part of ATR occurred during the years shown:

In 1982, the distributors, including limited partners, chose to be "at risk" for $2,895,000. They received no distributions

from ATR.

In 1983, the "at risk" amount was $4,235,000, with no distributions from ATR.

In 1984, the "at risk" amount was, again, $4,235,000. Distributions from ATR were $12,081, and the "Contingent Principal Sum" due USMPI was reduced by $4,066.

In 1985, the "at risk" amount was $1,340,000. ATR distributions were $23,448 with a reduction of the "Contingent Principal Sum" due USMPI of $29,744.

In 1986, the ATR distribution was $23,758 and the reduction of the "Contingent Principal Sum" was $59,113.

ATR and USMPI also entered into an "Agreement re Modification of Rights ..." under which ATR Product Marketing created an escrow fund that reduced the "Contingent Principal Sums" due USMPI. This fund was used to pay plaintiffs' legal fees and those of a number of distributors in tax litigation arising from the "ATR Territorial Distributorship Program." As of July, 1987 $123,000 was paid into the fund.

According to ATR's promotional material issued in 1982, a sale of one video disk system for $88,000 in a "minimum" territory—a population of 50,000 and a "Contingent Principal Sum" of $200,000—would cost ATR $50,000 and the distributor would receive $9,900. All sales outside designated territories would be credited solely to ATR. Thereafter, 55 to 60 percent of sales, in dollar amounts, took place outside the distributorship territories. In 1982, ATR's only sale of its product was one video disk player to ATR Product Marketing. In 1983, the only sale was one such player to an advertising agency that was retained by ATR.

In 1982, Albert Pitts was a paid consultant for ATR while its program was being organized and before any distributorships were sold. Since May, 1983 he has been signing checks for ATR Financial, which paid commissions on sales of ATR distributorships. ATR owns no patents. Until 1983, Albert Pitts sold mutual funds and tax-advantaged investments and his sons worked with him. He provided the ATR promotional package and, in 1982 and 1983, explained the ATR program to a number of purchasers of distributorships. In this period, he also trained his sons and others to enable them to sell distributorships. James Pitts presented the ATR program to members of the financial community and gave out the ATR promotional

package and private placement memorandums for the limited partnerships. Thomas Pitts did the same with purchasers of the distributorships.

The ATR promotional package of 1982 for individual distributors contained the following items:

(a) a cover sheet with table of contents consisting of two pages;

(b) "Overview" consisting of six pages;

(c) a letter dated July 15, 1982 from Rolph Fuhrman as president of USMPI;

(d) a letter dated July 15, 1982 from Nemecek, Gonzalez & Linsley;

(e) a tax opinion letter dated July 15, 1982 and addressed to USMPI consisting of 18 pages;

(f) "Territorial Distributorship Agreement" consisting of six pages;

(g) a receipt for payment to sales representative;

(h) a package entitled "tax forms" consisting of three pages, including a copy of Form 5213 entitled "Election to Postpone Determination with Respect to the Presumption that an Activity is Engaged in for Profit" and a copy of Schedule C—"Profit (or Loss) from Business or Profession";

(i) a form entitled "Consulting Agreement."

The contents of the promotional package in 1983 for individual distributors were the same as the 1982 package excepting a cover sheet with a table of contents and a tax opinion letter dated August 29, 1983 from another law firm in place of the tax opinion letter dated July 15, 1982. As to the two limited partnerships, each limited partner received a private placement memorandum, containing, among other items, a summary of the offering and the tax opinion letter of July 15, 1982.

The ATR promotional package states that "the total purchase price of each Territorial Distributorship consists of a 'Contingent Principal Sum' that is payable in a series of Incurred Annual Contingent Amounts." The "Contingent Principal Sum" for each territory was determined by multiplying the population by 10 cents per person times 40 years. This formula was not subject to change or negotiation. Before the present lawsuit, Albert Pitts did not retain anyone to perform a market appraisal of any territory and was not aware of such an appraisal.

Executive Design Investments, Inc., a Pennsylvania corporation, formed in 1973, is owned by Albert Pitts and his sons. It received from ATR Financial a commission on each limited partnership unit and ATR distributorship it sold. Albert Pitts, James Pitts and Thomas Pitts sold limited partnerships and distributorships through this corporation. Another corporation, EDI Inc., is a Nevada corporation incorporated in 1982.[3] It was authorized in 1982 by ATR to form limited partnerships for sales territories in Philadelphia and Delaware, and it became the general partner in those partnerships. It did not maintain any books of account as general partner for either partnership.

Albert Pitts is a limited partner in ATR Philadelphia and, as such, was required to pay $18,000 for his units. He did not make any payment toward this subscription price. The limited partners in both partnerships were required to pay $3,000 per unit of which the partnership was to retain $2,700 and $300 was sales commission. Each partnership paid ATR Financial the full "Guaranteed Performance Deposit."

Albert Pitts also acquired an individual distributorship. He did not pay the "Guaranteed Performance Deposit" of $5,000 per year during the first three years of ownership.

From 1982 to 1985, ATR and ATR Financial received $2,138,825 from the sale of distributorships. In 1982 and 1983, Albert Pitts received from ATR Financial $48,800 in sales commissions and $36,170 in consulting fees and also received commissions from Executive Design Investments, Inc. In those years, this corporation received from ATR Financial $113,850 in sales commissions and $120,933 in consulting fees.

In 1982 and 1983, James Pitts received from ATR Financial $3,000 in sales commissions, $3,000 in consulting fees, a draw of $3,600, and an advance of $6,000. In 1983, he also received from Executive Design Investments, Inc. $34,867 for sales of distributorships.

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3. EDI, Inc. and Executive Design Investments, Inc. are two separate corporations.

VII

In 1982 and 1983, Thomas Pitts received from ATR Financial $13,800 in sales commissions. In 1983, he received from Executive Design Investments, Inc. $41,165 for sales of distributorships.

II.

The following fact findings are based on evidence:

ATR's marketing business involves the "interactive video disk"—using laser technology to store and display images, much in the way that compact disks relate to sound. Advantages over video cassettes are random access to any place on the disk and a nearly unlimited disk life. Movies and games, as well as instructional material, can be shown. In 1982 and 1983, most of the market was limited to employee training. Production at an acceptable price has been a problem, but widespread consumer manufacturing and distribution may occur shortly. ATR began as a dealer in the "gray market of excess arcade game inventory." Tr. 60, Oct. 10, 1987. Albert Pitts made a secondary market in video disk equipment by buying and selling overruns and liquidations of outdated merchandise at discount. He became known as a source of hard-to-find, out-of-stock items. ATR has no exclusive arrangements with manufacturers or distributors. It continues to be in business, although its sales volume to 1987 was marginal.

Albert Pitts had no formal education or experience in engineering or computer science. He first learned about video disk technology in 1982, in connection with the ATR program.

Investors in ATR distributorships or the limited partnerships were solicited by unqualified claims of income tax advantages. A chart included in the promotional packages showed cash requirements of $30,000 and tax write-offs of $200,000. The description of the video disk business was brief, three pages, and vague—for example, no projections of income from sales. The explanation of the tax incentives, some 24 pages, together with a tax opinion letter and federal income tax forms, occupied most of the promotional material. Also, it was represented:

> In the event any portion of the projected tax benefit is denied by the Internal Revenue Service, the Territorial

> Distributor will be guaranteed ***at no additional cost*** (except for filing fees) competent legal services for representation in the United States Tax Court and the United States Circuit Court of Appeals. (Emphasis in original.)

Most of the distributorship agreements were signed for ATR by one of the plaintiffs, and they also acted for one general partner, EDI, in entering into the sales of limited partnership units. Although the distributors had the right to make sales within their territories, all of them executed agreements with ATR Product Marketing to take over the operations of the distributorships. Through this arrangement, Albert Pitts, the owner of ATR Product Marketing, retained control of all the distributorships. Excepting the possibility of business contacts, the distributors, as a result, were passive investors. They obtained an immediate and substantial tax deduction and, inferentially, relied on the distributorships to pay off the personal obligations that they had assumed.

In turn, Albert Pitts' concern was the distributors' ability to pay the "Guaranteed Performance Deposit"—not the "Contingent Principal Sum" or the "Incurred Annual Contingent Amount." These latter obligations were owed to USMPI, the non-profit corporation, not to Pitts or ATR. As of 1987, the total outstanding "Incurred Annual Contingent Amount" was about $12 million. The only evidence of a distributor's ability to pay was a certification in the distributorship agreement of net worth in excess of $1 million. No credit check or other investigation was made. According to Albert Pitts, no credit report was needed because the distributors were known to him to be persons of substantial means. He could not explain why the ATR agreement contained the net worth certification when the "at risk" obligation did not extend to ATR.

The ATR distributorship became a 4-to-1 tax shelter through a combination of the "at risk" tax rules[4] and the election of the accrual method of accounting. For example: An investor acquired a territory with a "Contingent Principal

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4 26 U.S.C. § 465.

Sum" of $200,000. In 1982, the investor incurred $40,000 in "Incurred Annual Contingent Amount" and elected to be "at risk" for that sum. Under the accrual method, an income deduction of $40,000 was claimed. The cash outlay, however, was the $10,000 Guaranteed Performance Deposit. The same tax events occurred in 1983 and 1984. At that point, the investor had purportedly incurred and deducted $120,000 in obligations, which translates into a $60,000 tax reduction for a taxpayer who was in the 50 percent tax bracket. *See* defendant's exhibit 18b.

According to the distributorship agreement, the price of a distributorship was its "Contingent Principal Sum." This amount was the value of the distributorship as stated or as represented to the investor. The total for the distributorships was $20 million. Other than the "Guaranteed Performance Deposit" it does not appear that these personal obligations were intended to be paid or enforced. The accurate or correct valuation of the distributorship, using a fair market value formula, did not exceed $1 million. In other words, the stated value exceeded the correct valuation by at least 20 times, or 2,000 percent.

This finding as to the correct valuation of the distributorship is supported by the opinion of the government's expert, Professor Jeffrey Jaffe of the Wharton School of Finance. As he explained, the only reasons for someone to invest in ATR was the large tax deductions available. Using a fair market value approach of the willing and knowledgeable seller and buyer, the aggregate value of the distributorships during 1982 and 1983 was between zero and $1 million. For this period, the discounted cash flow, or capitalization, valuation method would be unrealistic because there were no reliable projections of future earnings for the video disk industry in general or for ATR in particular. In 1982, this was a fledgling industry with high, indeterminate risks. The inability to project income is significant because it rules out the distributorships as realistic business investments. ATR had no prospectus, no researched, logical plan. Knowledgeable investors would be unwilling to put money into such a speculative, undefined, long-term venture on the strength of its economical potential. As Albert Pitts admitted, ATR could not raise working capital

through conventional sources. From the standpoint of its investors, ATR's business prospects were incidental, the tax incentives, primary.

Another measure of value, as given by Professor Jaffe, is comparative data, using other high technology businesses that were starting up at about the same time. In 1983, Sequent Corporation, a computer company, obtained $5 million in venture capital. In 1982-1985, ATR received $2.7 million from its investors in the form of "Guaranteed Performance Deposits." Sequent was a far better investment. It was formed by high-ranking former employees of Intel, a computer company, executives who had proven track records, a detailed business plan, and the experience and skills necessary to take over a successful new business. Albert Pitts and his sons lacked this type of background. Also, in 1983, the video disk industry was much less developed than the computer industry—and remains so.

As Professor Jaffe further analyzed, the most that usually can be generated in venture capital for a new, unknown company is about $1 million. Sequent's achievement was remarkable. Venture investors fund perhaps two percent of the opportunities offered to them. If ATR distributorships had not been presented as tax advantaged, it is unlikely that there would have been any investors. These factors account for a range of value from zero to $1 million.

Other specific items that investors would consider are that Albert Pitts did not put any capital in ATR.[5] Under the "Joint Management and Profit Sharing Agreement," the distributors would not receive any share of the profits from sales outside Pennsylvania-New Jersey-Delaware. ATR had no hard business advantages, such as patents or exclusive sales arrangements with manufacturers or others. It had no sales organization or structure. In short, it was an embryonic, almost formless enterprise with at most three managers who had no expertise. Likewise, the industry was immature and unpredictable.

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5. Although he testified that he did invest in the business, the evidence discloses that he lent ATR some $50,000, which was largely paid back. He admitted he did not pay for his limited partnership subscriptions or the "Guaranteed Performance Deposit" for his territory.

Jaffe valued the distributorships in the aggregate and did not place a value on each territory. The economic premise of the "Joint Management and Profit Sharing Agreement" is that for the purpose of allocating profits from sales, the territories are fungible. It is immaterial where in the territories the sales occur.

As Jaffe and plaintiffs' expert, Rockley Miller, publisher of a video disk trade magazine, agreed, projections for the industry were highly variable in 1982 and 1983. Some were optimistic, predicting strong growth. Others were negative. Some large manufacturers were leaving the market, having sustained substantial losses. Estimates consistently outran actual sales. The consumer market was tiny, and there were technological and sales barriers to its entry. In 1982 and 1983, ATR did not have five percent of the distribution of consumer disk equipment. It could not be compared with the developed network of distributors of consumer electronics, chain stores, and other well known outlets.

The ATR distributorships did not have a value equivalent to their "Contingent Principal Sums" inasmuch as the projections showing enough income to pay those amounts are pure speculation and have no factual foundation. As Albert Pitts admitted, in 1982 when he was selling the distributorships, these projections had not been made. Even if the distributorships in the aggregate were worth the actual amount paid for them, 2.7 million, they were grossly overvalued, considering the total "Contingent Principal Sums" of $20 million.

The tax deductions claimed by the investors amounted to 60 percent of the stated value of the distributorships—$12 million—since that was the figure that was accrued and "at risk."

III.

The Internal Revenue Code, 26 U.S.C. § 6700, provides:

(a) Any person who—

(1) (A) organizes (or assists in the organization)— ...

(iii) any ... plan or arrangement or

(B) participates in the sale of any interest in an entity or

plan or arrangement ... and ...

(2) makes or furnishes ...

(B) a gross valuation overstatement at to any material matter,

shall pay a penalty equal to the greater of $1,000 or 20 percent of the gross income derived or to be derived by such person from such activity.

Under § 6700(b), "gross valuation overstatement" is:

any statement as to the value of property or services if—

(A) the value so stated exceeds 200 percent of the amount determined to be the correct valuation, and

(B) the value of such property or services is directly related to the amount of any deduction or credit allowable under chapter 1 to any participant.

The government must prove by a preponderance of the evidence all facts predicate to the imposition of the penalty. 26 U.S.C. § 6703(a). *Franklet v. United States*, 578 F.Supp. 1552, 1559 (N.D.Cal.1984), *aff'd* 761 F.2d 529 (9th Cir.1985); *United States v. Music Masters*, 621 F.Supp. 1046, 1054 (W.D.N.C.1985).

A. Organizing and Participating in the Sale of a Plan

[1] In this case, the "plan or arrangement" constituting the tax shelter is the territorial distributorship program. Individual plaintiffs concede that they participated in the organization and sale of the program. Under the evidence each was intimately involved with the sale of distributorships and partnership units. They acted as representatives of the companies and were compensated by fees and commissions.

ATR argues that it did not organize or assist in the organization of or participate in the sale of a plan within the meaning of the statute. Its position is that it "did not participate other than by being sold." However, what was sold were distributorships, not the ATR corporation, and the undisputed evidence shows that ATR was actively involved in organizing and selling the distributorship program. ATR granted USMPI the right to market ATR distributorships, hired marketing consultants, and requested a legal opinion regarding registration of the sale of distributorships under the Securities Act of

1933. The distributorships were sold in the name of ATR, and representatives of ATR signed the distributorship agreements. As noted, ATR set up and controlled a legal defense fund for participants in the program. Given these facts, ATR was a "person who organizes" and "participates in the sale of a plan" under § 6700(a)(1).

B. Gross Valuation Overstatement

Under the statutory definition to be applied here, a gross valuation overstatement consists of a statement of the value of the territorial distributorships that "exceeds 200 percent of the amount determined to be the correct valuation," and that "value ... must be directly related to any deduction" ... "allowable" to the distributor. Both § 6700 requirements are met. *See United States v. Turner,* 601 F.Supp. 757, 766-67 (E.D.Wis.1985).[6]

1. Statement of Value

[2,3] Plaintiffs' claims that they did not make a "statement as to the value" of the distributorships within § 6700(b)(1) is without merit. The ATR document package, supplied to each investor, states: "The total purchase price of each Territorial Distributorship consists of a Contingent Principal Sum ...." This amount was placed in the appropriate blank in the territorial distributorship agreement after the distributor chose a territory. A person who puts a purchase price on an asset may be considered to have made a representation as to its value. *See United States v. United Energy Corp.,* 1987 U.S. Tax Cas. (CCH) p. 9216, at 87,367, 1987 WL 4787 (N.D. Cal.1987).

Plaintiffs cannot readily argue that the statement of the distributorship's price was not a statement of value. In legislating § 6700, Congress was concerned with the "widespread marketing and use of tax shelters undermin[ing] confidence in

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6. There are few reported decisions construing § 6700 and there appear to be none involving the type of working capital tax shelter involved in this case.

the fairness of the tax system and in the effectiveness of existing enforcement provisions." S.Rep. No. 494, 97th Cong., 2d Sess. 266, *reprinted in* 2 1982 U.S.Code Cong. & Admin.-News 781, 1014. Word games were anticipated. According to the legislative history, the seller of a tax shelter is to be held liable for a gross valuation overstatement "whether or not the accuracy of the statement of valuation is disclaimed." *Id.* at 1015. Drafted broadly, § 6700 speaks of "any statement as to the value of property or services." Within the terms and context of this tax provision, plaintiffs made a "statement of value" by executing the distributorship agreements. Defendant's exhibits 18c (Thomas Pitts); 19b (Albert Pitts); 19j (James Pitts). ATR set the formula by which the price was established and accepted each distributorship agreement at the price as fixed.

2. The Correct Valuation of the Distributorships

[4,5] The statute makes a distinction between the "correct valuation" and the value stated by or on behalf of the seller. The "correct valuation" is the fair market value—the amount payable in a bona fide commercial transaction between a willing buyer and a willing seller, neither being compelled to buy or sell and both having knowledge of relevant facts. *Music Masters,* 621 F.Supp. at 1055. As discussed in the legislative history:

> The penalty for gross evaluation overstatement will have no effect on bona fide commercial or investment transactions in which, for example; a willing and knowledgeable buyer purchased from a willing and knowledgable seller for cash because such a purchase price will define the value of the investment.

S.Rep. No. 494, 97th Cong., 2d Sess. 267, *reprinted in* 2 1982 U.S.Code Cong. and Admin.News 1015.

Ascertaining a "correct valuation" for ATR's territorial distributorships may be difficult to do, but even at the top of the realistic range, the stated value is many times greater than the "correct valuation."

3. Direct Relation of the Value Stated to a Deduction

[6] Plaintiffs argue that since the notes for the "Incurred Annual Contingent Amounts" are with recourse, they must be paid from distributorship profits or by the investors themselves, giving economic substance to the transaction. Also, the allowable deduction is computed from the amount of debt, not the fair market value of the distributorships. Therefore, according to plaintiffs, the deduction is related to the debt incurred and does not involve a "statement of value."

This contention misses the relevant point. The amount of debt incurred is itself a statement of value, being the purchase price upon which the deductions are based. The amount of the debt, recourse or not, exceeds by more than 200 percent the correct value of the distributorships.

Also, the recourse debt appears to lack bona fides. Albert Pitts and Anthony Tedeschi, a territorial distributor, testified that they expected such payments to be made, but the nature of the transactions and the material used to market the distributorships strongly suggest otherwise.[7]

IV.

The following conclusions are made:

1. Plaintiffs organized and participated in the sale of a plan and furnished gross valuation overstatements that were directly related to the amount of an allowable deduction.

2. In so doing, plaintiffs violated 26 U.S.C. § 6700.

3. The government has proved each element of the violations by a preponderance.

4. Plaintiffs are liable for the penalties assessed, which they agreed were properly computed.

It is so ordered.

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7. Although not explained, it appears that the purpose of having the "at risk" debt payable to a nonprofit corporation was to attempt to avoid the tax effects of having it accrued as income to ATR. The device of an interest-free loan from USMPI insulated ATR, a for-profit corporation, from having to declare the accrued obligations of the investors as accrual income.

ENTRY OF JUDGMENT

AND NOW, this 3rd day of April, 1989 judgments are hereby entered in favor of defendant United States of America and against plaintiffs American Technology Resources, Albert S. Pitts, James A. Pitts and Thomas M. Pitts as follows, for the reasons set forth in Memorandum of Decision Under Fed. R.Civ.P. 52(a):

1. The provisions of 26 U.S.C. § 6700 are applicable to each plaintiff for selling abusive tax shelters as to the tax years 1982 and 1983;

2. Plaintiffs are liable to defendant United States of America (Internal Revenue Service) under 26 U.S.C. § 6700 for the following penalties:

—American Technology Resources	1982—	$ 78,400
	1983—	116,025
		$194,425
—Albert S. Pitts		6,000
—James A. Pitts		4,000
—Thomas M. Pitts		8,000

Costs on plaintiffs.

Filed January 17, 1990

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 89-1431

AMERICAN TECHNOLOGY RESOURCES,
Appellant

V.

UNITED STATES OF AMERICA

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 89-1432

JAMES A. PITTS,
Appellant

V.

UNITED STATES OF AMERICA

XVIII

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 89-1433

ALBERT S. PITTS,
Appellant

v.

UNITED STATES OF AMERICA

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 89-1434

THOMAS M. PITTS,
Appellant

v.

UNITED STATES OF AMERICA

On appeal from the United States District Court
for the Eastern District of Pennsylvania
(D.C. Civil Action Nos. 86-5769, 86-5770,
86-5773, 86-5774)

Argued October 24, 1989

Before: HUTCHINSON, NYGAARD and WEIS,
Circuit Judges

(Opinion filed January 17, 1990)

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OPINION OF THE COURT

NYGAARD, *Circuit Judge*.

This is an appeal from a judgment in favor of the United States. The district court adjudicated appellants liable under 26 U.S.C. § 6700, the penalty provision for promoting abusive tax shelters for selling grossly overvalued distributorship franchises. Appellants raise two issues: first, whether the district court erred in concluding that the value of the American Technology Resources, ("ATR"), distributorships was "directly related" to the amount of any deduction allowable under the Internal Revenue Code; and, second, whether the district court abused

its discretion in qualifying the government's expert and consequently erred by denying appellants' motion for directed verdict on the ground that the United States presented no evidence of the ATR distributorships' value.[1] We conclude that the value of the ATR distributorship is directly related to the amount of a franchise deduction allowable under 26 U.S.C. § 1253(d) and that the district court did not abuse its discretion in qualifying Professor Jeffrey Jaffe as an expert in business valuation. We will affirm.

I

Appellant ATR, a Nevada corporation with its principal place of business in Media, Pennsylvania, produces and sells videodisc equipment. Appellants Albert Pitts, James Pitts and Thomas Pitts (The Pitts) own 77.5 percent of the issued and outstanding shares of ATR. All three are very active in ATR's operation. In 1982, Albert Pitts became president of ATR.

In November, 1982, ATR entered into an agreement with United States Motion Picture Institute (USMPI), whose president is Rolph Fuhrman, former president of ATR, permitting USMPI to sell ATR territorial distributorships in the tri-state Philadelphia area. The buyers of the distributorships would have an exclusive right to sell ATR's products for forty-three years. ATR and USMPI developed a promotional package for the ATR distributorships and the Pitts sold the distributorships. In all, thirty-four distributorships were sold.

The sale of each distributorship was described in the promotional package and structured as follows:

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1. Appellants also seem to raise a third issue in the context of challenging the qualifications of Professor Jaffe: whether Professor Jaffe's testimony assisted the trier of fact to decide a fact in issue. We will also address this issue.

XXI

The cost of the distributorship was the product of the term of the distributorship in years multiplied by a factor equal to ten cents per resident of the territory. This amount was called the Contingent Principal Sum. The purchaser could elect to pay the Contingent Principal Sum in a series of twenty-three installments called the Incurred Annual Contingent Amount. The first three installments of the Incurred Annual Contingent Amount would each equal twenty percent of the Contingent Principal Sum and would be due in years one, two and three, respectively. No Incurred Annual Contingent Amount would be due in years four through ten. After year ten, an installment equal to two percent of the Contingent Principal Sum would be due each year for twenty years. The Incurred Annual Contingent Amount also would be reduced each year by an amount determined by a formula based on product cost and sales.

If preferred, the purchaser could defer payment to USMPI of the Incurred Annual Contingent Amount by electing to be 100 percent personally liable for the debt ("at risk"). Under this option, payment would not be due until twenty years after the debt was incurred. The obvious effect of the election is to create a deduction for franchise costs pursuant to 26 U.S.C.§ 1253(d) with no corresponding cash outlay. Under this election the only cash outlay by the purchasers initially would be payment of three Guaranteed Performance Deposits, each equaling five percent of the Contingent Principal Sum. These payments would not be credited towards the Contingent Principal Sum.

.ATR's promotional package focused heavily on the tax advantages of purchasing a distributorship. ATR emphasized that the purchaser "should receive a tax write-off equivalent to the portion of the Incurred Annual Contingent Amount for which he specifically elects to be personally 'at risk.' This can be as much as

four times the amount of the Guaranteed Performance Deposit." App. at 109. ATR also assured the buyer that if any deductions were denied, ATR would provide legal services "at no additional cost." *Id.*

Thirty-two individuals and two limited partnerships purchased ATR distributorships. In 1982 and 1983, USMPI did not receive any money from these purchasers towards the Contingent Principal Sum; all elected to be "at risk" for their Incurred Annual Contingent Amount. The "at risk" amount for those two years was $7,130,000. In 1984 through 1986, USMPI received a minimal amount towards the Contingent Principal Sum which was generated from the profits of sales. In 1984 and 1985, the "at risk" amount was $5,575,000.

In 1986, the IRS assessed penalties against the appellants by authority of 26 U.S.C. § 6700 for promoting an abusive tax shelter for tax years 1982 and 1983. Pursuant to 26 U.S.C. § 6703(c), appellants paid fifteen percent of the penalties and filed an action in the United States District Court for the Eastern District of Pennsylvania contesting their liability. The case was tried before the court which made its findings of fact and conclusions of law, adjudicating appellants subject to the penalties of Section 6700. *American Technology Resources v. United States*, 709 F. Supp. 610 (E.D. Pa. 1989).[2]

The district court found that the purchasers of the distributorships were solicited by unqualified claims of tax advantages. The promotional brochure contained only a brief description of the video-disc business and a lengthy discussion of potential tax deductions. The court also found that the purchasers were passive

2. Most of the district court's findings of fact were derived from an extensive pre-trial stipulation submitted to the court by the parties.

investors who sought the tax advantages of a 4-to-1 tax shelter. The court further found that the Pitts were each intimately involved in the sales of the distributorships.

The court accepted the valuation testimony of Professor Jeffrey Jaffe, the government's expert witness who testified that the aggregate value of the distributorships did not exceed $1 million. Professor Jaffe based his conclusion on what the average venture capitalist would raise in the market for a business with the characteristics of ATR. He noted that ATR lacked a business plan and failed to have any patents or exclusive arrangements with manufacturers; the unknown future of the industry; and, inexperienced management as factors limiting the value of the distributorships. Upon this testimony the court concluded that the aggregate sale price of the distributorships ($20 million) was at least two hundred percent greater than the actual value.

Upon these findings, the district court concluded that the government proved by a preponderance of the evidence that a penalty was warranted. The court concluded, "Plaintiffs organized and participated in the sale of a plan and furnished gross valuation overstatements that were directly related to the amount of an allowable deduction." 709 F. Supp. at 619. The court entered judgment for the United States.

II

Appellants filed this timely appeal. We have jurisdiction pursuant to 28 U.S.C. § 1291. The district court's findings of fact are reviewed under the clearly erroneous standard. Fed. R. Civ. P. 52. *See Pleasant Summit Land Corp. v. Comm'r of Internal Revenue*, 863 F.2d 263, 268 (3d Cir. 1988) *cert. denied*, 110 S. Ct. 260 (1989). The district court's construction of the statutory phrase "directly related" is subject to plenary

review. *Strick Corp. v. United States*, 714 F.2d 1194 (3d Cir. 1983) *cert. denied*, 466 U.S. 971 (1984). The district court's qualification of the government's expert witness must be sustained unless manifestly erroneous. *Aloe Coal Co. v. Clark Equipment Co.*, 816 F.2d 110, 114 (3d Cir.) *cert. denied*, 484 U.S. 853 (1987).

III

Section 6700(a) of the Internal Revenue Code, 26 U.S.C. § 6700, provides, in pertinent part,

(a) Imposition of penalty. -- Any person who --

> (1)(A) organizes (or assists in the organization of) --
>
> > (i) a partnership or other entity,
> >
> > (ii) any investment plan or arrangement, or
> >
> > (iii) any other plan or arrangement, or
>
> (B) participates in the sale of any interest in entity or plan or arrangement referred to in subparagraph (A), and
>
> (2) makes or furnishes (in connection with such organization or sale) --
>
> > (B) a gross valuation overstatement as to any material matter,
>
> shall pay a penalty equal to the greater of $1,000 or 20 percent of the gross income derived or to be derived by such person from such activity.

Gross valuation overstatement is defined in Section 6700(b)(1) as meaning,

> any statement as to the value of any property or services if --

(A) the value so stated exceeds 200 percent of the amount determined to be the correct valuation, and

(B) the value of such property or services is directly related to the amount of any deduction or credit allowable under chapter 1 to any participant.

26 U.S.C. § 6700 (b)(1).

Appellants challenge the district court's conclusion that the value stated by them for the distributorships is "directly related" to any allowable deduction or credit. In support they argue that the value of its distributorships is not directly related to the allowability of any deduction or credit. Appellants explain that the deduction available under their distributorship plan is found in 26 U.S.C. § 1253(d)(1) which allows, as a business deduction, amounts paid or incurred on account of a transfer of a franchise which are contingent on the use of the franchise. They claim this deduction arises because the purchasers elected to be "at risk" for the Incurred Annual Contingent Amount and thus, "incurred" an amount on account of a transfer of a franchise. According to appellants' argument, the deduction is allowed, not because it is directly related to the value of the distributorship, but because it is directly related to the "at risk" nature of the transaction.

Appellants miss the point. Section 6700 does not require the value of the property to be directly related to the *allowability* of a deduction. It quite clearly states that the value be directly related to the *amount* of the deduction. Here, the value given the distributorships is directly related to the amount of a deduction allowable under the Internal Revenue Code (the Code). Under Section 1253(d)(1), a business deduction is allowable for amounts incurred on account of a transfer of a franchise. The amount incurred by the purchasers of

the distributorships is the Incurred Annual Contingent Amount. This amount, a percentage of the Contingent Principal Sum, is set by appellants. Thus, the amount of a purchaser's tax deduction is a function of the value placed upon that distributorship by appellants. As value increases, the amount of the deduction increases. This proportional relationship satisfies the "directly related to amount" language of Section 6700. We hold that the district court did not err by concluding that the value of the distributorships was "directly related" to the amount of a deduction allowable under the Code.

IV

Appellants next argue that the district court abused its discretion by qualifying the government's expert, Professor Jeffrey Jaffe. Rule 702 provides,

> If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise.

Appellants make two arguments based upon Rule 702. First, they argue that Professor Jaffe did not testify about a "fact in issue," and should not have been allowed to testify. Appellants assert that the "fact in issue" in this case is the value of the ATR distributorships and that Professor Jaffe's testimony on the amount of capital a venture capitalist would have raised had ATR been sold on the open market is not instructive. Appellants' construction of Rule 702 is too restrictive. The purpose of Rule 702 is to admit expert testimony that is helpful to the trier of fact. *Linkstrom v. Golden T. Farms*, 883 F.2d 269 (3d Cir. 1989). We interpret the helpfulness standard broadly. *Id.* An expert witness need not testify specifically about a fact in issue so long as his testimony is considered

helpful by the trier of fact in determining a fact in issue.

Even if we assume that appellants are correct that the value of ATR is not the value of the ATR distributorships, the question is still whether testimony about the value of ATR would assist the court to determine the value of the distributorships. The ATR distributorships are an exclusive license to sell ATR products in a certain geographic territory. This exclusive license to sell ATR products is a component of the value of ATR. Thus the value of the distributorships is a function of the value of ATR. We conclude that testimony about the value of ATR could help the district court determine the value of ATR's distributorships. Its decision to admit the testimony is not error.

Appellants next argue that Professor Jaffe was not qualified to testify about the value of ATR's distributorships. Specifically, appellants assert that Professor Jaffe did not know how to value a distributorship; that distributorships are different from the businesses which Professor Jaffe had expertise to value; and, that he knew nothing about the videodisc industry or running a distributorship. We disagree.

Under Rule 702, "an expert witness must have such skill, knowledge, or experience in the field as to make it appear that his opinion will probably aid the trier of fact in his search for the truth." *Aloe Coal Co. v. Clark Equipment Co.*, 816 F.2d 110, 114 (3d Cir. 1987). The basis of qualification can be practical experience as well as academic training and credentials. *Hammond v. International Harvester Co.*, 691 F.2d 646 (3d Cir. 1982).

Here, Professor Jaffe obtained his expertise from both practical experience and academic training. Professor Jaffe is an Associate Professor of Finance at the Wharton School of Business at the University of Pennsylvania. He teaches courses in speculative

markets, corporate finance, investments, and real estate finance. He has a Ph.D. in finance from the University of Chicago. He is a member of several professional finance organizations and has written a number of published articles on corporate finance and investments. He has also performed consulting work valuing a number of businesses, varying from publicly-held companies to privately-held companies, like ATR. In summary, Professor Jaffe appears very well qualified to testify about the value of a business and we conclude that the district court did not abuse its discretion when it qualified him as an expert.

Although appellants' argument is couched in terms of whether Professor Jaffe was qualified, the real thrust of their arguments appear to challenge the helpfulness of Professor Jaffe's testimony, as well as its credibility. The district court concluded, and we agree, that his testimony would be helpful. Finally, credibility was a decision for the trier of fact to whom we now defer.

V

In summary, we hold that the district court correctly concluded that the value placed on the distributorships by appellants was directly related to the amount of a deduction allowable under the Code, and that the court did not abuse its discretion by admitting the testimony of Professor Jaffe or by qualifying him as an expert. We will affirm.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit

(A.O. U.S. Courts, G.M.C. Printing, Phila., Pa. 215-568-4264)

XXIX

UNITED STATES TAX COURT

In the Matter of: ALBERT S. PITTS, — and — MARIAN C. PITTS, Petitioners, —vs.— COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket Nos. 20535-85 1146-88 1223-88

1320 Tax Court Courtroom
841 Chestnut Building
841 Chestnut Street
Philadelphia, Pennsylvania
Monday, March 19, 1990

The above-entitled matter came on for hearing, to notice, at 9:46 a.m.

BEFORE: HON. STEPHEN J. SWIFT, Judge

On behalf of Petitioners:

BIGELOW, MOORE AND TYRE
BY: JOSEPH F. MOORE, Esquire
Easton House
540 South Marengo Avenue
Pasadena, California 91101

On behalf of Respondent:

RUSSELL K. STEWART, Esquire
MICHAEL D. BAKER, Esquire
Office of the District Counsel
Room 10424
Internal Revenue Service
Philadelphia, Pennsylvania 19106

ANN RILEY & ASSOCIATES, LTD. (202) 293-3950

EXCERPTS OF DIRECT TESTIMONY
OF IRS EXPERT WITNESS, ZWEIFLER
(Pages 210 and 211 of transcript)

BY MR. STEWART:

Q Is it your understanding that all the territorial distributorships were sold at a value of about $20 million?

A Yes.

THE COURT: A value of $20 million?

THE WITNESS: Yes.

MR. STEWART: The contingent principle sums for all the territorial distributorships totaled $20 million.

THE COURT: Is that the value?

MR. STEWART: That is the value that they are deducting under 1253 (d) or using as a basis for their value to deduct under 1253 (d).

THE COURT: The value?

MR. STEWART: It's the cost.

THE COURT: The tax cost or value?

MR. STEWART: That's what they are deducting in this particular —

THE COURT: That's not value. It's the cost.

MR. STEWART: All right. That's their cost.

THE COURT: Words mean something. We should use the right words in our questions. Tax cost and value are two totally different things. I'm having trouble following some of your questions because of the words that are being used. So, please use the right words.